

Chapman Client Alert

April 22, 2020

(Updating an April 13, 2020 Client Alert)

Current Issues Relevant to Our Clients

Questions and Answers about the Municipal Liquidity Facility Established by the Federal Reserve under the CARES Act

As described in our April 9, 2020, Client Alert [*Federal Reserve Announces Six New Funding Facilities Based on CARES Act Authorizations*](#), on April 9 the Federal Reserve issued term sheets for six “new” funding facilities under the CARES Act. This Client Alert describes in more detail the Municipal Liquidity Facility briefly outlined in that April 9 Client Alert. The term sheet for the Municipal Liquidity Facility is [attached](#).

What is the purpose of the municipal liquidity facility?

The term sheet states that the facility “will support lending” to States, the District of Columbia, cities with a population over 1 million, and counties with a population over 2 million. The facility, however, does not “support” such lending by purchasing municipal debt in the secondary market. Instead, the facility provides for purchases of certain short-term securities directly from the State (including DC), city, or county that issues (or on whose behalf another entity issues) the securities. The facility, therefore, provides direct funding to the borrowers.

How will the Federal Reserve fund States, cities, or counties under the facility?

On April 16, 2020, the Federal Reserve filed with Congress a report that specified the Federal Reserve Bank of New York (FRBNY) would be the sole lender under the Municipal Liquidity Facility.¹

The FRBNY will make loans to a single special purpose vehicle (SPV) to finance the SPV’s purchases of “Eligible Notes” issued by “Eligible Issuers.”

What is an Eligible Issuer under the facility?

Any State, including the District of Columbia, any city with a population of more than 1 million, and any county with a population of more than 2 million.

Can an Eligible Issuer delegate its borrowing to an instrumentality it has established to manage its cash flows?

Yes. The term sheet explicitly includes such instrumentalities as Eligible Issuers, but only one entity can issue Eligible Notes under this facility for any single Eligible Issuer. Thus, a State could issue Eligible Notes directly or through a designated “instrumentality,” but it could not do both. The same would be true for any county or city eligible to issue Eligible Notes under this facility.

How many eligible issuers could there be in any single State?

There is no limit on the number of cities or counties that could be Eligible Issuers, so long as each has the required population. Some States will have only one Eligible Issuer (the State itself or its designated “instrumentality”), because those States have no cities or counties with populations over 1 or 2 million, as applicable. Some States have multiple cities with populations over 1 million and/or counties with populations over 2 million. Currently in the US, there are 11 cities with populations over 1 million and 15 counties with populations over 2 million.²

What is an Eligible Note that the SPV could purchase under the facility?

The term sheet states: “Eligible Notes are tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), and other similar short-term notes issued by Eligible Issuers, provided that such notes mature no later than 24 months from the date of issuance. In

each case, a note's eligibility is subject to review by the Federal Reserve."

Obviously, the Federal Reserve will determine on a case by case basis what "notes" it will permit the SPV to purchase. It seems clear the Federal Reserve intends to fund notes that are expected to be repaid from future (1) taxes and other revenues, (2) bond issuances, or (3) other moneys that the issuer can foresee receiving.

Is two years the maximum maturity for the Eligible Notes sold to the SPV?

Yes. As quoted above, the term sheet specifies that Eligible Notes must "mature no later than 24 months from the date of issuance."

Is there a limit on the amount of Eligible Notes an Eligible Issuer can sell to the SPV?

Yes. The term sheet states: "The SPV may purchase Eligible Notes issued by or on behalf of a State, City, or County in one or more issuances of up to an aggregate amount of 20% of the general revenue from own sources and utility revenue of the applicable State, City, or County government for fiscal year 2017."

To establish such amounts, the term sheet links to this U.S. Census Bureau webpage for those revenue amounts.
<https://www.census.gov/data/datasets/2017/econ/local/public-use-datasets.html>

What does it mean that a State "may request that the SPV purchase Eligible Notes in excess of" this limit "to assist political subdivisions and instrumentalities that are not eligible for the Facility"?

The Federal Reserve seems to contemplate that it might approve extra Eligible Note issuances to permit a State to provide additional funding to cities and counties that do not meet the in excess of 1 million or 2 million population requirements for direct issuances of Eligible Notes or for other political subdivisions of the State.

Such political subdivisions that are not Eligible Issuers could have "general revenue from own sources and utility revenue" or otherwise have funds that would justify borrowings, if they had the required population.

Again, the Federal Reserve may clarify this issue in a FAQs or other publication providing more detail about the facility.

What are the fees for an Eligible Issuer to sell Eligible Notes under this facility?

A 10 basis points (*i.e.*, 1/10 of 1%) origination fee on the principal amount of the Eligible Notes sold to the SPV.

This is the only fee specified in the term sheet.

Aside from that 10 bps origination fee, what is the pricing for the Eligible Notes?

The term sheet states: "Pricing will be based on an Eligible Issuer's rating at the time of purchase with details to be provided later."

This seems to contemplate that the interest rate on an Eligible Note will be based on the Eligible Issuer's rating at the time the SPV purchases the Eligible Note. The Federal Reserve will need to provide such pricing information, either through general guidelines or specific pricing information for each Eligible Note.

Can an issuer call the Eligible Notes it has sold to the SPV?

Yes. The term sheet states: "Eligible Notes purchased by the SPV are callable by the Eligible Issuer at any time at par."

Is an Eligible Issuer restricted in how it can use the proceeds from the sale of Eligible Notes?

Yes. The term sheet states: "An Eligible Issuer may use the proceeds of Eligible Notes purchased by the SPV to help manage the cash flow impact of income tax deferrals resulting from an extension of an income tax filing deadline; potential reductions of tax and other revenues or increases in expenses related to or resulting from the COVID-19 pandemic; and requirements for the payment of principal and interest on obligations of the relevant State, City, or County. An Eligible Issuer may use the proceeds of the notes purchased by the SPV to purchase similar notes issued by, or otherwise to assist, political subdivisions and instrumentalities of the relevant State, City, or County for the purposes enumerated in the prior sentence."

This suggests an Eligible Issuer will have fairly broad discretion in how it uses the proceeds from Eligible Note sales, including for paying principal of and interest on obligations incurred for purposes unrelated to the COVID-19 pandemic. Aside from such payments on outstanding debt, however, it seems there will need to be some connection to the pandemic.

When can Eligible Issuers begin selling Eligible Notes to the SPV?

The Federal Reserve will need to announce that date.

For how long will the SPV make such purchases?

Until September 30, 2020, unless the Federal Reserve extends that date. The term sheet states: "The SPV will cease purchasing Eligible Notes on September 30, 2020, unless the

Board and the Treasury Department extend the Facility. The Reserve Bank will continue to fund the SPV after such date until the SPV's underlying assets mature or are sold."

For More Information

If you would like further information concerning the matters discussed in this article, please contact the Chapman attorney with whom you regularly work.

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- 1 <https://www.federalreserve.gov/publications/files/municipal-liquidity-facility-4-16-20.pdf>
 - 2 World Population Review <https://worldpopulationreview.com/> (viewed 4.12.2020).

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Municipal Liquidity Facility

Effective April 9, 2020¹

Facility: The Municipal Liquidity Facility (“Facility”), which has been authorized under Section 13(3) of the Federal Reserve Act, will support lending to U.S. states and the District of Columbia (together, “States”), U.S. cities with a population exceeding one million residents² (“Cities”), and U.S. counties with a population exceeding two million residents³ (“Counties”). Under the Facility, a Federal Reserve Bank (“Reserve Bank”) will commit to lend to a special purpose vehicle (“SPV”) on a recourse basis. The SPV will purchase Eligible Notes directly from Eligible Issuers at the time of issuance. The Reserve Bank will be secured by all the assets of the SPV. The Department of the Treasury, using funds appropriated to the Exchange Stabilization Fund under section 4027 of the Coronavirus Aid, Relief, and Economic Security Act, will make an initial equity investment of \$35 billion in the SPV in connection with the Facility. The SPV will have the ability to purchase up to \$500 billion of Eligible Notes.

Eligible Notes: Eligible Notes are tax anticipation notes (TANs), tax and revenue anticipation notes (TRANs), bond anticipation notes (BANs), and other similar short-term notes issued by Eligible Issuers, provided that such notes mature no later than 24 months from the date of issuance. In each case, a note’s eligibility is subject to review by the Federal Reserve. Relevant legal opinions and disclosures will be required as determined by the Federal Reserve prior to purchase.

Eligible Issuer: An Eligible Issuer is a State, City, or County (or an instrumentality thereof that issues on behalf of the State, City, or County for the purpose of managing its cash flows), in each case subject to review and approval by the Federal Reserve. Only one issuer per State, City, or County is eligible.

Limit per State, City, and County: The SPV may purchase Eligible Notes issued by or on behalf of a State, City, or County in one or more issuances of up to an aggregate amount of 20% of the general revenue from own sources and utility revenue of the applicable State, City, or County government for fiscal year 2017.⁴ States may request that the SPV purchase Eligible Notes in excess of the applicable limit in order to assist political subdivisions and instrumentalities that are not eligible for the Facility.

Pricing: Pricing will be based on an Eligible Issuer’s rating at the time of purchase with details to be provided later.

Origination Fee: Each Eligible Issuer that participates in the Facility must pay an origination fee equal to 10 basis points of the principal amount of the Eligible Issuer’s notes purchased by the SPV. The origination fee may be paid from the proceeds of the issuance.

¹ The Board of Governors of the Federal Reserve System (“Board”) and Secretary of the Treasury may make adjustments to the terms and conditions described in this term sheet. Any changes will be announced on the Board’s website.

² Source: U.S. Census Bureau, Annual Estimates of the Resident Population: April 1, 2010 to July 1, 2018, as of April 6, 2020 (<https://www.census.gov/data/tables/time-series/demo/popest/2010s-total-cities-and-towns.html>).

³ Source: U.S. Census Bureau, “Population, Population Change, and Estimated Components of Population Change: April 1, 2010 to July 1, 2019 (CO-EST2019-alldata)” dataset as of April 6, 2020 (https://www.census.gov/data/datasets/time-series/demo/popest/2010s-counties-total.html#par_textimage_739801612).

⁴ Source: U.S. Census Bureau, 2017 State & Local Government Historical Datasets and Tables, as of April 6, 2020 (<https://www.census.gov/data/datasets/2017/econ/local/public-use-datasets.html>).

Call Right: Eligible Notes purchased by the SPV are callable by the Eligible Issuer at any time at par.

Eligible Use of Proceeds: An Eligible Issuer may use the proceeds of Eligible Notes purchased by the SPV to help manage the cash flow impact of income tax deferrals resulting from an extension of an income tax filing deadline; potential reductions of tax and other revenues or increases in expenses related to or resulting from the COVID-19 pandemic; and requirements for the payment of principal and interest on obligations of the relevant State, City, or County. An Eligible Issuer may use the proceeds of the notes purchased by the SPV to purchase similar notes issued by, or otherwise to assist, political subdivisions and instrumentalities of the relevant State, City, or County for the purposes enumerated in the prior sentence.

Termination Date: The SPV will cease purchasing Eligible Notes on September 30, 2020, unless the Board and the Treasury Department extend the Facility. The Reserve Bank will continue to fund the SPV after such date until the SPV's underlying assets mature or are sold.